40

DISCUSSION PAPER

# A Market-Oriented Strategy for Small and Medium Scale Enterprises

Kristin Hallberg

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*(Continued on the inside back cover.)*

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# A Market-Oriented Strategy for Small and Medium Scale Enterprises

Kristin Hallberg

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The International Finance Corporation (IFC), an affiliate to the World Bank, promotes the economic development of its member countries through investment in the private sector. It is the world's largest multilateral organization providing financial assistance directly in the form of loan and equity to private enterprises in developing countries.



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## CONTENTS

## FOREWORD

This IFC Discussion Paper, the fortieth in the series, deals with small- and medium-scale enterprises and how governments and aid agencies can best encourage their development. Small- and medium-scale enterprises play a very important role in developing economies, and assisting them is a task which ranks high in the priorities of the World Bank Group and in particular of the IFC. Ms. Hallberg takes a fresh look at the issues and offers a market-oriented strategy for SMEs.

Guy Pfeffermann
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& Economic Adviser of the Corporation

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## ABSTRACT

This paper investigates the economic rationale for intervention in support of small- and medium-scale enterprises, on both theoretical and empirical grounds. It argues that the justification for SME interventions lies in market and institutional failures that bias the size distribution of firms, rather than on any inherent economic benefits provided by small firms. The role of the State is mainly to provide an enabling business environment that opens access to markets and reduces policy-induced biases against small firms. Governments can accelerate the development of markets for financial and non-financial services suited to SMEs by promoting innovation in products and delivery mechanisms and by building institutional capacity Improving the development impact of SME strategies will require much more attention to the monitoring and evaluation of intervention outcomes.

## Introduction

Governments in both industrialized and developing countries provide a wide variety of programs to assist small- and medium-scale enterprises (SMEs). Despite the success of SME strategies in a few countries, the majority of developing countries have found that the impact of their SME development programs on enterprise performance has been less than satisfactory. As its client governments search for more effective ways of assisting SMEs, the World Bank Group is being asked to provide lessons of experience and guidelines for intervention. Underlying the search for best practice are some basic questions: What is the justification for public intervention in the first place? Should SMEs be singled out for assistance? If there is a justification for government intervention, what form should that intervention take?

This paper suggests a framework for SME intervention to help the Bank Group's client countries design SME strategies, gauge the effectiveness of assistance programs, and achieve the objective of raising SME competitiveness. The paper focuses on SMEs as opposed to microenterprises (see Box 1), though many of the same principles apply to microenterprise development as well—in fact, some are derived from the foundations of the microfinance revolution.

**Box 1. The Definition of SMEs**

Small- and medium-scale enterprises (SMEs) are a very heterogeneous group. They include a wide variety of firms—village handicraft makers, small machine shops, restaurants, and computer software firms—that possess a wide range of sophistication and skills, and operate in very different markets and social environments. Their owners may or may not be poor. Some are dynamic, innovative, and growth-oriented; others are traditional "lifestyle" enterprises that are satisfied to remain small. In some countries, SME owners and workers are (or are perceived to be) dominated by members of particular ethnic groups, such as the native Pribumi in Indonesia or indigenous groups in Bolivia.

Microenterprises are normally family businesses or self-employed persons operating in the semi-formal and informal sectors; most have little chance of growing into larger scale firms, accessing bank finance, or becoming internationally competitive. Serving them often requires distinct institutions and instruments, such as the group-based lending methodologies used by some microfinance institutions. In contrast, SMEs usually operate in the formal sector of the economy, employ mainly wage-earning workers, and participate more fully in organized markets. SME access to formal finance is a desirable possibility, and SMEs are more likely than microenterprises to grow and become competitive in domestic and international markets.

The statistical definition of SMEs varies by country, and is usually based on the number of employees or the value of assets. The lower limit for small-scale enterprises is usually set at 5 to 10 workers and the upper limit at 50 to 100 workers. The upper limit for "medium-scale" enterprises is usually set between 100 and 250 employees. Since statistical definitions vary, it is very difficult to compare size distributions across countries (Figure 1). However, one should not be overly concerned about the lack of consistency in employment-based SME definitions, since the number of employees, viewed in isolation from the size of markets or the economy, may be misleading. For example, a 50-employee firm in the U.S. would be considered "smaller" (relative to the size of the U.S. economy) than a 50-employee firm in Bolivia. Moreover, other characteristics of the firm, such as the degree of informality or the level of technological sophistication, may matter more than the number of employees as a segmentation factor.

The paper is organized as follows. The first section considers the economic importance of SMEs on both theoretical and empirical grounds, placing SME development within the broader context of the evolution of industrial structure. The next sections identify policy biases and market distortions that affect SME competitiveness, and should be the focus of SME development strategies. The paper then illustrates the application of these principles in three areas: the business environment, financial services, and business development services. Special attention is paid to the market-development-versus-market-distortion debate surrounding subsidies. Finally, the paper proposes a framework for evaluating the impact of SME interventions.

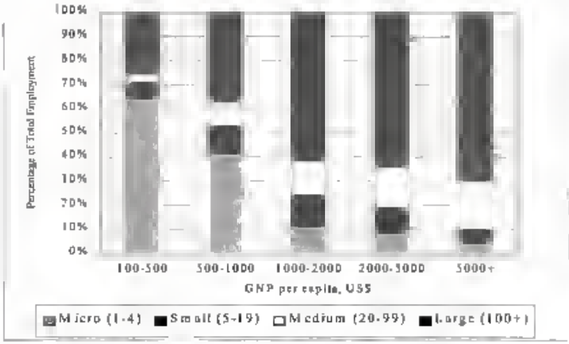
**The Economic Importance of SMEs: Separating Myth from Reality**

It is often argued that governments should promote SMEs because of their greater economic benefits compared to large firms—in terms of job creation, efficiency, and growth. This section takes a closer look at these arguments and their empirical evidence.

***Share of Firms and Employment***. In most developing countries, microenterprises and small-scale enterprises account for the majority of firms and a large share of employment. In Ecuador, for example, firms with fewer than 50 employees accounted for 99 percent of firms and 55 percent of employment in 1980; in Bangladesh, enterprises with fewer than 100 workers accounted for 99 percent of enterprises and 58 percent of employment in 1986.

The relative importance of small producers varies significantly across countries and, within a given country, across stages of development over time. Comparative studies of manufacturing show a common pattern in the transformation of the size distribution of firms as industrialization proceeds (Figure 1). In low-income countries, the vast majority of firms are micro- or small-scale, existing alongside a few large-scale enterprises. In middle-income countries, medium-scale enterprises begin to account for a relatively larger share of production and employment. In most countries, the trend toward larger firm size continues as per-capita income increases. The exceptions to this rule are found mainly in Asia. In Taiwan, China for example, the size distribution of firms has remained relatively constant over the past thirty years, even as the structure of production changed from labor-intensive manufacturing to high-tech computer industries. On average, however, small-scale enterprises play a declining role as countries develop.

**Figure 1: Distribution of Employment by Firm Size**




Source: Snodgrass and Biggs (1996), p.53. Based on industrial census data from 34 countries, mainly in the 1960s and 1970s. GDP per capita in real terms, 1985-88; firm size based on the number of employees.

***Labor Intensity.*** Small firms employ a large share of the labor force in many developing countries, but are they more labor demanding than large firms (for a given scale of production)? Many analysts argue that, within industries, SMEs are more labor intensive than large firms. However, the evidence suggests that enterprise scale is an unreliable guide to labor intensity: many small firms are in fact more capital-intensive than larger firms in the same industry.[1] Labor intensity exhibits more variation across industries than among firm-size groups within industries—leading some authors to suggest that efforts to make economic growth more labor-demanding should focus on altering the pattern of demands in favor of labor-intensive industries rather than on supply-side efforts to change the size distribution of firms.[2] The fact that SMEs employ a large share of the labor force in developing countries may be more a reflection of the product composition of production in those countries than an inherent labor-intensity of small firms.

***Job Creation.*** Apart from labor intensity, it is often argued that SMEs are important for employment growth, i.e., job creation. Here again, the evidence does not support the conventional wisdom. While gross job creation rates are substantially higher

[1] See, e.g., Little, Mazumdar, and Page (1987).

[2] Ibid., p. 314, and Snodgrass and Biggs (1996), p. 29.

for small firms, so are gross destruction rates. This is because small firms exhibit high birthrates and high death rates, and many small firms fail to grow. In developed countries, net job creation rates (gross job creation less gross job destruction) do not exhibit a systematic relationship to firm size.[3] For example, in the United States between 1973 and 1988, despite a widespread belief to the contrary, small manufacturing firms did not consistently create more jobs on a net basis (after allowing for jobs eliminated and firms that went out of business) than large firms.[4] There is some evidence that the same conclusion holds for developing economies.

Since small firms have higher gross job creation and destruction rates than large enterprises, SMEs may offer less job security than larger firms. In the U.S., for both new jobs and the typical existing job, job durability increases with firm size.[5] Yet it appears that job destruction during recessions is lower in SMEs than in large enterprises—perhaps due to greater wage flexibility in SMEs. In other words, SME owners may temporarily accept lower compensation during recessions in order to hold on to their business.[6]

***Efficiency.*** Measures of enterprise efficiency (e.g., labor productivity or total factor productivity) vary greatly both within and across industries. Firm size may be associated with some other factors that are correlated with efficiency, such as management skill and technology, and the effects of the policy environment. In the U.S. manufacturing sector, industries in which larger firms have a greater market share have greater productivity growth. Most studies of developing countries show that the smallest firms are the least efficient, and there is some evidence that both small and large firms are relatively inefficient compared to medium-scale firms.[7]

It is often argued that SMEs are more innovative than larger firms. In developed countries, SMEs often follow "niche strategies," using high product quality, flexibility, and responsiveness to customer needs as means of competing with large-scale mass producers.[8] Many small firms bring innovations to the marketplace, but the contribution of innovations to productivity often takes time, and larger firms may have more resources to adopt and implement them.[9]

***Wages and Benefits.*** While there are many exceptions to the basic pattern, the weight of evidence suggests that larger employers offer better jobs in terms of wages, fringe benefits, working conditions, and opportunities for skills enhancement, as well as

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[3] Davis, Haltiwanger, and Schuh (1993); Haltiwanger (1999); Storey and Johnson (1987).

[4] Nasar (1994), cited in Snodgrass and Biggs (1996), p. 10.

[5] Davis, Haltiwanger, and Schuh (1993).

[6] Haltiwanger (1999)

[7] Little, Mazumdar, and Page (1987), p. 313.

[8] Snodgrass and Biggs (1996), p. 33.

[9] Acs, Morck, and Young (1999).

job security.[10] In low-income countries, small enterprises have much lower productivity levels than larger firms, and this is reflected in the lower wages and non-wage benefits paid by SMEs compared to large firms. There is some evidence that this divergence in labor productivity and wage rates between small and large firms narrows as industrialization proceeds,[11] though in the U.S. the gap in wages paid by small and large plants has widened over the past 20 years.[12]

***Social, Political, and Equity Justifications.*** SMEs are often said to contribute to a more equal distribution of income or wealth. To the extent that SME owners and workers are in the lower half of the income distribution, promoting the growth of SMEs may lead to a more equitable distribution of income. However, SME owners and workers are unlikely to be the poorest of the poor, so that SME promotion may not be the most effective poverty alleviation instrument. In addition, the strategy of promoting SMEs to achieve equity objectives may be less effective than more direct methods, e.g., income transfers.

In reality, the desire of governments to promote SMEs is often based on social and political considerations rather than on economic grounds. Often, SMEs are (or are perceived to be) the domain of certain ethnic groups or political constituencies, such as the Pribumi in Indonesia or women in traditional societies. Sometimes, the growth of small firms is seen as part of a process of democratization and increased social stability, or as an instrument of regional development. An evaluation of the merits of these arguments is outside the scope of this paper.

***Conclusions.*** It is often argued that SME promotion is justified on grounds of the job-creating prowess of SMEs or of their greater efficiency and growth. Attempts are often made to draw a causal link between SMEs and poverty alleviation so as to justify policies and subsidies in favor of SMEs. But the empirical evidence supporting many of these claims is very mixed, making it difficult to justify SME promotion on the basis of inherent economic benefits of smallness.

The real reason that developing country governments should be interested in microenterprises and SMEs is because they account for a large share of firms and employment—in other words, because "they are there."[13] Searching for further justification to promote smallness as an instrument of poverty alleviation is not necessary: it is enough to recognize that microenterprises and SMEs are the emerging private sector in poor countries, and thus form the base for private sector-led growth.

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[10] Davis, Haltiwanger, and Schuh (1993); Brown, Hamilton, and Medoff (1990).

[11] Snodgrass and Biggs (1996), p. 32.

[12] In 1992, the average production worker in a small plant in the U.S. was paid $10.49 per hour, 30 percent less than the $15.09 paid to the typical worker in a large plant (source: comments from Eric Oldsman).

[13] Little, Mazumdar, and Page (1987), p. 313.

What determines the size of an individual firm, and thus the size distribution of firms in an economy? A review of the industrial organization literature finds three main groups of factors:[14]

- ***Economies of Scale.*** Technology-based economies of scale determine the minimum efficient scale of production. Economies of scale of production, along with diseconomies of scale of organization technology, determine efficient firm size. The size distribution of firms is then determined by a combination of efficient firm size, market size, and the product composition of production in the economy (which in turn depends on resource endowments).
- ***Transactions Costs.*** In the theory of the firm originally developed by Coase,[15] the firm is viewed as an alternative to the market—a mechanism of allocating resources and structuring transactions (contracting, bargaining, etc.). Transactions for which the market is a highly costly form of governance are withdrawn from the market and internalized by the firm, thus increasing the size of the firm. The nature and size of transactions costs can change over time: for example, new communications technologies may lower the costs of transacting with suppliers, leading firms to outsource activities previously handled internally.
- ***Market Structure.*** The size distribution of firms reflects the distribution of market power as well as segmentation and distortions in input and output markets that determine cost differentials between large and small firms. Some of these give an advantage to larger firms: for example, the fixed costs and transactions costs associated with regulations. Others can give SMEs an advantage: for example, small firms may be legally exempted from labor market policies such as minimum wages or social benefits, permitting them to hire labor more cheaply than large enterprises.

The size distribution of firms evolves over time within the broader context of economic development and the evolution of industrial production. As countries develop, the share of agriculture declines, with a corresponding growth in industry and services, and average plant size increases.[16] The size distribution of firms responds to changes in the composition of production (and therefore in the importance of scale economies), transportation costs (that change the spatial concentration of production and market size), and transactions costs (in turn a function of the legal and regulatory framework, institutional development, etc.). There is no "ideal" size distribution of firms, but rather

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[14] A summary of these approaches is contained in You (1995).

[15] Coase (1937, 1988).

[16] See Snodgrass and Biggs (1996), pp. 41-80.

an "equilibrium" size distribution determined by resource endowments, technology, markets, laws, and institutions.

Some of the factors that determine tho equilibrium size distribution of firms—technology-determined economies of scale, resource endowments, and consumption patterns—are in a sense "natural" determinants of firm size that are usually not targets of government intervention. Others—transactions costs, some types of fixed costs, the degree of competition, and segmented and distorted markets—are influenced by policy and institutional factors that are within the realm of public policy. For example:

- For markets to allocate resources efficiently, all market participants must have the same relevant information. In the real world this assumption seldom holds, and the resulting market failures can create biases against small firms. In credit markets, it is difficult or costly for banks to obtain information on the creditworthiness of potential SME clients. If lenders perceive the risk of lending to that clientele to be greater than it actually is, they will charge higher interest rates or refrain from lending to that clientele altogether.

- Even if SME credit risks are correctly priced, nsury laws may prevent banks from charging interest rates that would cover the high unit cost of lending to small firms. In addition, imperfect competition in credit markets may cause banks to focus on larger, more profitable clients.

- Beyond its nature as a public good and source of market failure, the fixed cost of acquiring information can create a cost disadvantage for small firms. For example, the ability of SMEs to enter and compete effectively in export markets is discouraged by the high fixed cost of acquiring information on foreign buyers, distribution channels, quality standards, and new technologies.

- SMEs' demand for non-financial services such as training or consultancy may be low because they do not recognize that these services can raise their productivity and growth—in other words, because of a lack of information—or because of the risk that these benefits will not occur. As a result, SMEs tend to use fewer external sources of advice than larger firms.

- Laws governing tho use of property as collateral often exclude moveable assets such as machinery or livestock. Since moveable assets often comprise a greater share of the assets of smaller firms compared with larger ones, this has a particularly negative impact on access to credit by SMEs.

- Some policies and regulations may be biased *de facto* in favor of smaller firms, for example when they are excluded from or neglected by the administration of tax and labor laws. Others are biased against SMEs—for example, export and investment incentives often require a minimum level of exports or investment to participate.[17]

### Implications for SME Development Strategies

The preceding analysis of the economic rationale for SME intervention suggests that an SME development strategy is in reality just a "private sector development strategy," recognizing that the majority of firms are small, that they may face different constraints and opportunities than large firms, and that the types of institutions and instruments best suited to their needs may be underprovided in distorted and segmented markets. It points government action toward market-completing interventions and the elimination of policy biases by:

- Addressing the market failures that create cost disadvantages for SMEs, restrict their access to markets, and inhibit the development of markets for a diverse range of financial and non-financial services appropriate for small firms;
- Improving transactional efficiency in financial, product, and input markets relevant to SMEs, by facilitating access to information and developing mechanisms to manage risk;
- Reconsidering public policies and regulations that discriminate against small firms or produce fixed costs that create a competitive disadvantage for them; and
- Investing in public goods that open market access and build enterprise competitiveness—including infrastructure (information, communications, power, water, and transport) as well as education and technology development.

This approach contrasts with traditional SME promotion strategies, which rely heavily on the direct and subsidized provision of financial and non-financial services to SMEs. It places much greater emphasis on creating an enabling environment for SME competitiveness, and on developing markets for SME-relevant services rather than substituting for them. It attempts to broaden the coverage and impact of government programs by using the private sector to deliver services, and focusing scarce public resources on facilitating market transactions and investing in public goods.

[17] Young (1994).

At the institutional level, the emerging approach to SME development has many parallels to the recent revolution in microfinance. In microfinance, it was recognized that overall financial sector reform was necessary but not sufficient to bring financial services to the poor. The provision of financial services to the low-income segment of the market was accelerated by developing innovative products and delivery mechanisms suited to that segment of the market. To achieve long-term viability of microfinance institutions, the approach emphasizes institutional strengthening, cost-effective delivery and management, and the charging of interest rates sufficient to cover the costs of small-scale lending. In the same vein, recognizing that SMEs may need different types of services, institutions, and delivery mechanisms than larger firms, the government can accelerate market development by promoting innovation and building institutional capacity.

The next sections discuss how this approach to SME development works in three areas: the business environment, financial services, and business development services. Illustrative examples are shown in boxes, and a summary follows in Table 1.

### Business Environment

The performance of all firms—small as well as large—is affected by the business environment in which they operate. A stable macroeconomy, an open trade and investment regime, and a competitive financial sector establish the fundamental conditions for a vibrant private sector. Well-developed physical infrastructure—transportation, warehousing and port facilities, communications networks—expands markets and facilitates transactions throughout the productive sector. Social infrastructure investments in education and health care build the capabilities of the productive sector workforce.

Nevertheless, there are certain aspects of the business environment that are of particular relevance to SME competitiveness: those that affect market access, the cost of acquiring information, transactional efficiency and risk, and the fixed costs of doing business. In most countries, these SME-specific aspects of the business environment would include some or all of the following:

- Barriers to entry and non-competitive behavior in markets where SMEs are potentially competitive;[18]

- Expensive and time-consuming regulatory requirements such as licensing and registration;

[18] Even in industries normally thought of as favoring natural monopolies, SMEs may be able to serve some segments of the market. In many urban areas of Africa and Latin America, small independent water providers bring basic water service to marginal communities.

- Official and unofficial levies that discourage small enterprises from growing and becoming formal;[19]

- The legal framework for commercial transactions and the resolution of disputes, that can affect transactions with unknown firms;

- Laws governing the protection of business and intellectual property, and the use of property as collateral;

- Tax structures that distort incentives and discriminate against small firms;

- Government procurement procedures that discourage successful bidding by SMEs;

- Zoning regulations that restrict SME operations and entry into high-income markets;

- Labor market rigidities that make hiring and firing workers difficult and expensive, and limit the flexibility and mobility of the labor force; and

- Infrastructure that opens access to information and markets, particularly transportation, market facilities, and communications infrastructure.

The fact that a regulation raises the cost of doing business doesn't necessarily mean that the regulation should be softened or eliminated. Environmental regulations, for example, impose a cost on the business sector, but these costs may be outweighed by the social benefits of improved environmental quality. Nevertheless, when doing the cost-benefit analysis of such regulations, one factor to consider is how the burden is distributed across different types of firms. In some cases, adding flexibility in the implementation of regulations can be an important way to ease the burden on small enterprises.[20]

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[19] In Indonesia, official and unofficial levies are estimated to raise SMEs' cost of doing business by as much as 30 percent.

[20] In Chile, for example, the government recently simplified the duty drawback system to reduce the burden of administrative costs on small firms; in Bolivia, parts of the tax system were drastically simplified for small firms. In the U.S., the Small Business Regulatory Flexibility Act requires regulatory agencies to consider ways of reducing the cost of compliance for small firms.

**Box 2. Institutional Bias Against Small Firms**

Institutional obstacles may be particularly severe for small firms because they represent fixed costs, which a larger firm can more easily absorb. In addition, larger firms may receive better treatment than small firms because they are more politically connected and better organized.

A 1996 survey of almost 4,000 firms in 69 countries was conducted as part of the background work for the *1997 World Development Report*. Entrepreneurs were asked for their subjective evaluation of different aspects of the institutional framework in their country, including security of property rights, predictability of rules and policies, reliability of the judiciary, problems with corruption and discretionary power in the bureaucracy, and disruptions due to changes in government.

In many of the developing countries surveyed, firms of all sizes complained of the lack of even the most basic institutional infrastructure for a market economy. Crime and theft were listed as serious problems that substantially increased the cost of doing business. In Latin America, Sub-Saharan Africa, the former Soviet Union, and Eastern Europe, almost 80 percent of entrepreneurs reported a lack of confidence that the authorities would protect their person and property from criminals. Over 70 percent said that judicial unpredictability was a major problem in their business operations.

Small firms in developing countries reported significantly more problems than did large firms in almost all dimensions of the institutional framework: access to information about policy changes, the predictability of the judiciary, discretionary bureaucracies, and corruption. Smaller firms in developing countries also reported that they had to bribe more often than large firms. In contrast, there were few significant differences between small firms and large firms in the high-income countries surveyed. Only in terms of corruption did small and local firms report more negatively than large and foreign firms.

Source: Brunetti, Kisunko, and Weder (1998) and World Bank (1997).

## Financial Services

SMEs often complain that their growth and competitiveness are constrained by a lack of access to financing and the high cost of credit. Recent events in Latin America and East Asia lend credibility to the argument that SMEs are more likely than larger firms to be denied new loans during a financial crisis.[21] In most countries, because competition in the banking sector is limited, banks have not been under pressure to develop their lending to smaller clients. In addition, SME access to the formal financial sector is constrained by the high risks and transactions costs—real or perceived—associated with commercial lending to that segment of the market. Lenders are faced with a lack of reliable information on borrowers, difficulties in enforcing contracts (the result of inadequate legal frameworks and inefficient court systems), and the lack of appropriate instruments for managing risk. Often, the problem is compounded by supervisory and capital adequacy requirements that penalize banks for lending to enterprises that lack traditional collateral.

[21] During the 1995-96 economic crisis in Mexico, the sharp decline in domestic bank credit affected new lending for SMEs and domestic market-oriented firms in particular; see World Bank (1998).

In the traditioual appreach te SME development, governments have provided credit to SMEs through first-tier develepment banks, second-tier credit facilities channeled through banks and other financial institutions, and portfelie reqnirements on banks—often snpplemented by credit guarantee schemes. Subsidized interest rates and gnarantees were common in the past and continue to be nsed in many countries. In part, this reflects a presumption that the high cost ef credit is the main constraint facing SMEs—even though there is evidence that SMEs care mere abont access to credit than its cest. The traditienal approach of subsidized credit also may have been a reflectiou of the importance of state-owned banks in developing-country financial markets.

Directed and subsidized credit programs have done little to achieve what shonld be their fundamental ebjective: increasing the access of small enterprises to financial services. Instead, they inhibit the development of snstainable financial institntions and often-foster a "non-repayment culture" ameng enterprises. Low rates ef lean recevery push ex-post subsidies even higher than those intended in credit programs. Credit subsidies also create distortions in financial markets, since they discourage firms from using non-credit forms of financing. The traditienal approacb has failed to deal with the fundameutal problems that raise the cost of credit and mako banks relnctant to serve SMEs: the high risks and transactiens costs (real er perceived) associated with cemmercial lending te the small-scale segment ef the market.

A market-eriented strategy fer improving SME access to financing focuses ou reducing the risks and transactiens costs associated with this segment of the market, strengthening the capacity ef financial institntions to serve smaller clients, and increasing competitive pressure iu financial markets. The aim is to increase the number ef financial institutions that find lending to SMEs to be profitable, and therefore sustainable. Elements ef this strategy wonld inclnde:

- Rednciug barriers to entry, e.g., by recensidering capital adeqnacy reqnirements and prudential regulatiens that may be inappropriate fer financial institutiens serving smaller clients;

- Rednciug the risks associated with lending to small bnsinesses, focusing on laws governing the enfercement of contract, forfeiture and collectien of collateral, and the use ef mevable assets as collateral;

- Developing the policy, legal, and regulatory frameworks that are essential to the develepment ef innovative financial institutions and instruments, including ventnre capital, small equity investments, and leasing;

- Promoting innevatien in specialized lending technologies that reduce the administrative costs associated with credit application, monitoring, and payment;

- Strengthening the capacity of financial institutions to evaluate SME creditworthiness in a cost-effective manner, for example through the use of credit scoring techniques; and

- Improving information on the creditworthiness of potential borrowers, by promoting the establishment of credit bureaus and ways to help SMEs prepare business plans and financial projections.

**Box 3. Strengthening the Small-Scale Lending Capacity of Commercial Banks**

The InterAmerican Development Bank and the European Bank for Reconstruction and Development are experimenting with strategies to encourage private financial institutions to lend to SMEs. Some years ago, IDB introduced a credit facility earmarked for small business lending. Because IDB believed that the availability of additional funds for onlending would be sufficient to induce banks to participate in the program and that the banks themselves would know best how to set up small-scale lending activities, banks were not given access to technical assistance funds.

These assumptions turned out to be wrong. As a result of financial sector reforms, loanable funds became less scarce so that additional foreign funding was less attractive to banks than it had been previously. In addition, the banks did not bother to, or did not manage to, develop adequate lending technologies.

IDB decided to change its approach by providing technical assistance to certain handpicked commercial banks to develop small-scale lending technologies and train staff. It proved difficult to find banks willing to accept the new technologies, in particular the requirement that lending decisions be decentralized to branch offices. There was political resistance as well: critics maintained that subsidizing commercial banks was unacceptable. Nevertheless, a small number of banks accepted the offer of cooperation, and have begun to make credible efforts to develop the small business market.

The EBRD is pursuing a similar strategy in its Russia Small Business Fund by extending credits to private partner banks and designing a technical assistance component in collaboration with them, without government involvement. Moreover, EBRD is open to acquiring an equity stake in banks that make a success of small business lending. It appears that EBRD has been able to exert a more direct influence on its partner banks than did the IDB, whose project was designed with greater government involvement.

Source: Schmidt and Zeitinger (1995).

### Business Development Services

Business development services (BDS) include a wide variety of non-financial services such as labor and management training; extension, consultancy, and counseling; marketing and information services; technology development and diffusion; and mechanisms to improve business linkages through subcontracting, franchising, and business clusters. These services form an important part of the "market support structure" that helps build SME competitiveness.

Traditionally, governments and donors have provided BDS through public institutions or non-governmental organizations, often on a free or subsidized basis. There is broad consensus that publicly provided business development services suffer from being too general and supply-driven, of poor quality, with insufficient awareness of cost control. Since both the quantity and quality of publicly provided or publicly funded services are limited by the amount of subsidies available, program coverage tends to be low—typically only five to ten percent of the target population of SMEs. Systematic monitoring and evaluation of program impacts are rarely done, but all too often, SMEs report that the programs are irrelevant to their needs.

The emerging strategy for BDS focuses on developing markets for services that are appropriate to and demanded by SMEs, rather than on the direct provision of BDS by governments and donors.[22] The lessons of recent experience show that facilitating the provision of services by private providers and stimulating the demand for them by small enterprise clients is an effective way to raise the coverage, quality, and sustainability of services, and to increase their impact on small enterprise performance. The shift toward market provision of BDS reflects a move toward a "systems approach" analogous to the microfinance revolution. As with microfinance, it leads to emphasis on being business-like and demand-led at the institutional level. It directs government and donor intervention toward facilitating transactions between small enterprise "clients" (as opposed to "beneficiaries") and BDS providers seeking to develop profitable market niches.

The starting point for BDS market development is an understanding of the existing market—what is currently provided and by whom (including informal and indigenous providers); the characteristics, needs, and willingness-to-pay of small enterprises; and the nature of market failures that constrain market development.[23] Often, the delivery and price of services may not be easily visible, since SMEs tend to rely on inter-firm relationships and informal sources of information rather than formal, external service providers.

Supply-side interventions to promote BDS market development can be used to extend and replicate models of financially sustainable, cost-effective services (see Box 4). Demand-side interventions, such as matching grants and vouchers, may be justified on a temporary basis if markets are under-developed because small enterprises lack knowledge (or perceive high risks) of the benefits of BDS. Nevertheless, the success of demand-side subsidies should be judged by whether they develop rather than distort markets (see the following section). In general, it is believed that subsidies are less distortionary at the

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[22] A summary of the emerging "paradigm" guiding donor interventions in BDS is contained in Steel, Tanburn, and Hallberg (forthcoming, 2000).

[23] Sometimes, the types of BDS products demanded by small enterprises can be surprising. In Kenya, SMEs are willing to pay the full cost of enterprise exchange visits, in which they travel to towns outside their market area to tour other SMEs in their industry. Other interesting case studies are contained in Tanburn (1999).

pre-delivery stage (e.g., market assessment, product development) and post-delivery stage (monitoring and evaluation) than at the level of the BDS transaction.

**Box 4. Financially-Sustainable Business Development Centers**

SwissContact, a Swiss NGO, is attempting to develop commercially viable and sustainable institutions providing marketing and technical assistance services to SMEs. In Indonesia, SwissContact has supported six Business Development Centers (BDCs) that offer business diagnostics, specific technical skills training, technology advice, and business administration services. In Peru, eight BDCs offer marketing services in sectors such as garments, agroindustry, and carpentry.

The philosophy of SwissContact is that the development of business-like institutions takes place in an environment which employs "real" market and business conditions, not in an environment that relies on donor subsidies. The BDCs are selected through a bidding process that involves detailed business plans and a financial commitment from the bidder. The tender process is open to any kind of organization—associations, private firms, NGOs, etc.—and deliberately builds on existing BDS institutions rather than creating new ones.

At the heart of the contract between the business center and SwissContact are financial targets that form the basis for SwissContact financial support, which typically covers up to 50 percent of operating costs during the first six to twelve months of the contract. The most important indicator is financial sustainability: current contracts specify that 100 percent self-financing be achieved in two to three years. Other target indicators include cost effectiveness (inputs per client or inputs against deliverable outputs) and the financial contribution (gross margin) of different services. In addition to financial support, SwissContact offers scholarships for staff training, market surveys, networking with other business development centers, auditing services, and benchmark information for monitoring purposes.

SwissContact's experience demonstrates that there is a market for small-scale business services and that BDS providers can become sustainable institutions and therefore do not require ongoing subsidies from governments or donors. Nevertheless, challenges remain: there is a risk that BDCs will work only with relatively well-off SMEs in order to generate a profit, and the cost of SwissContact's technical assistance and monitoring are quite high. The success of a BDC depends critically on the capabilities of the management team.

Source: Hagmaner (1999).

As in microfinance, the challenge in BDS is to develop low-cost service "products" and delivery mechanisms that meet the needs and willingness-to-pay of the smallest scale clients. BDS institutions can often achieve lower cost and higher quality when they involve the private sector in the delivery of services—through industry associations, larger firms linked to SMEs through buyer or supplier relationships, and other SMEs themselves. Recent advances in information and communications technology as well as improved Internet access offer opportunities to lower the cost of information, training, marketing, and business linkages. Standardized or group approaches for some services (such as basic business diagnostics) can be a cost effective way of delivering services, although they may be inappropriate for more sophisticated services to larger clients (such as technology upgrading services for medium-scale firms). Indicators of performance of BDS organizations themselves can provide a solid base for appraisal, evaluation, and improved design of future interventions.

Efforts to develop private BDS markets should be complemented with a reduction and rationalization of public sector involvement. Reducing the traditional government role in service provision will take time, but can be encouraged by requiring steady increases in cost recovery to achieve financial sustainability; more business-like institutional management; using the private sector to deliver services; and more rigorous impact evaluation tied to budgetary allocations. Rationalization of public expenditure on BDS can be accompanied by selective privatization of programs that have achieved full cost recovery. In the long run, subsidies should limited to those supporting the provision of public goods; in the short run, they may be justified if they contribute to the development of markets, with a clear strategy for their reduction as this objective is achieved. Besides contributing to BDS market development, these efforts make better use of scarce fiscal resources.

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Table 1. Market-Oriented SME Interventions

| | Open Access to Markets, Accelerate Market Development | Invest in Public Goods, Build Institutional Capacity | Reduce and Rationalize Traditional Public Interventions |
|---|---|---|---|
| Business Environment | • Competition policy<br>• Licensing and registration requirements, administrative fees<br>• Commercial transactions law<br>• Intellectual and commercial property rights<br>• Tax, labor legislation<br>• Government procurement<br>• Flexibility in the implementation of regulations | • Infrastructure (transport, ports, market facilities, communications, information technology)<br>• Information (markets, standards, technologies)<br>• Monitoring of SME performance and impact of policies and interventions<br>• Public/private partnerships at local level to improve business environment | • Reconsider policies that reserve certain sectors for small-scale enterprises or grant them special protection<br>• Seek greater neutrality across firm sizes in tax and labor legislation and enforcement |
| Financial Services | • Financial sector competition policy<br>• Collateral legislation<br>• Prudential regulation and supervision<br>• Interest rate ceilings<br>• Regulations governing leasing, venture capital, equity markets | • Innovation in loan products, lending methodologies, delivery mechanisms, risk assessment methodologies (e.g., credit scoring)<br>• Credit bureaus, registries<br>• Training and TA to financial institutions serving SMEs | • Reduce direct lending through public financial institutions<br>• Reduce SME lending (portfolio) requirements on financial institutions<br>• Eliminate subsidized credit lines and credit guarantee schemes |
| Business Development Services | • Target subsidies for market development to specific market failures<br>• Information on service providers, impact of services<br>• Enforce competition in service markets | • Innovation in products (especially for the smallest firms), delivery mechanisms<br>• Development of performance and impact indicators<br>• Training and TA to private BDS providers<br>• Limit long-term subsidies for BDS to public goods (e.g., information, labor and management training) | • Increase cost recovery for publicly-provided or subsidized services<br>• Improve management and cost control in public BDS institutions<br>• Condition budgetary allocations to the achievement of impact<br>• Reduce duplication across agencies in services provided<br>• Use the private sector to deliver services<br>• Privatize service providers when financially sustainable |

When designing interventions to develop markets for SME services, it is important to bear in mind a basic principle: all else equal, subsidies distort markets. If their long-term objective is to promote the development of markets, one should ask whether their market-development effect outweighs their market-distortion effect. In turn, this depends upon whether the subsidy leads to a solution to the market failure that inhibited market development in the first place.

Figure 2 illustrates the potential market-distortion effects of a demand-side subsidy: a voucher scheme for consultant services. In this example, the voucher scheme shifts out the demand curve for consultant services, resulting in the purchase of (Q' – Q) additional services. If the supply of consultant services is fairly elastic—because there is a fairly competitive supply of local and/or foreign consultants—the voucher scheme increases the volume of services purchased with little or no impact on consultants' fees. This is shown as Case I, where the increase in fees received by consultants is shown as an increase from P to Ps. But if the supply of consultant services is inelastic—as would occur in a less well-developed market for SME consultants—the main effect of the voucher scheme is to raise the price of consultants' services, with a small impact on the amount purchased (Case II). In the longer run, the supply of consultants is likely to become more elastic, depending upon the case of adjustment and the time period over which adjustment takes place.

**Figure 2: Short-Run Effects of a Demand-Side Subsidy**

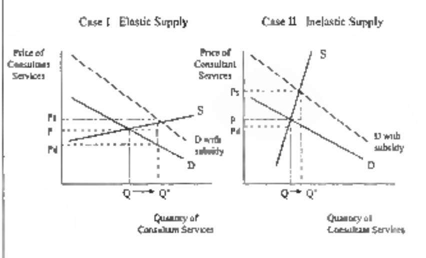



Figure 2 illustrates the concept that the "incidence" of the subsidy—the share of the subsidy ultimately received by the demanders (SMEs) versus suppliers (consultants) —depends on the elasticities of demand and supply, not on who initially receives the subsidy. If the supply of consultants is relatively inelastic, most of the subsidy ((Ps – P) x

Q') is simply transferred to consultants, and only a small share ((P – Pd) x Q') is received by SMEs. A similar picture could be drawn for supply-side interventions. A subsidy to the supply side (e.g., sharing the start-up costs of new BDS providers) increases the volume of services purchased—but the division of the subsidy between suppliers (BDS providers) and demanders (SMEs) depends on the responsiveness of demand.

It is a common fallacy that demand-side subsidies such as vouchers and matching grants are "demand-led" or "demand-driven" interventions. While these programs have the advantage of allowing the SME client to choose among service providers (sometimes subject to certification by the government or program administrator), true market demand refers to the willingness of an SME to pay for services offered, in the context of the resources and alternatives available to the SME.

A justification for demand-side and supply-side subsidies can be made if they encourage market development in the long run. In the example above, if consulting services are under-demanded because SMEs fail to appreciate their "true" benefits, temporarily subsidizing services may encourage firms to try them, producing a "demonstration effect" that increases demand. As the willingness to pay for services increases, the demand curve shifts outward and the subsidy can be phased out. Supply-side development is also possible: temporarily subsidizing BDS providers may cause them to search for better products and delivery mechanisms, resulting in lower a cost of service provision. As the market is developed through innovation, the supply-side subsidy could be reduced.

Whether interventions in markets for SME services make sense depends upon whether their market-development effects outweigh their market-distortion effects. In turn, this depends upon whether the subsidy leads to a solution to the problem that inhibited market development in the first place. When deciding when and how to intervene, governments and donors need to begin with a good understanding of the structure and performance of existing markets. If the willingness to pay for support services is thought to be too low, is this because SMEs don't understand their true value, or because of the poor quality or inappropriate design of existing services? Are there few providers of services in the market because of a lack of knowledge of appropriate products, or because subsidized public institutions are crowding out private providers? Subsidies that are not targeted to the specific market failures constraining BDS market development are likely to be more distortionary than developmental, and since they do not solve the underlying problem, they may be more difficult to remove.

**Evaluating the Success of Interventions**

In traditional SME interventions such as directed credit programs and technical assistance, the evaluation of the results of interventions frequently has been limited to measurement of program inputs or program outputs—for example, the number of loans granted, the number of clients served by a business advisory program, or the amount of market information provided. Attempts to measure the impact of interventions on SME performance are infrequently done and are plagued by measurement and methodological problems.

Improving the developmental impact of SME strategies will require much more attention to monitoring and evaluation of interventions. The trend away from public provision of services and toward the development of markets calls for different approaches to the evaluation of the success or failure of intervention. Corresponding to the focus on institutional and market development, monitoring and evaluation should cover:

- ***Institutional Performance***, according to indicators of:
    - coverage (outreach), in terms of the number of individuals, enterprises, and organizations reached by an intervention;
    - cost effectiveness, with the objective of providing a service (of a given type and quality) at the lowest possible cost; and
    - financial sustainability, which refers to the extent to which the service can be provided without dependence on subsidies—i.e., the extent to which revenues generated from clients or other non-subsidy sources equal or exceed the costs of service provision.

Institutional performance evaluation provides program managers and other stakeholders with continuous feedback on whether or not the program is reaching its intended clientele, what types of activities are more or less successful, and how the program can be better designed and managed. It also provides a basis for accountability in the use of public resources.

- ***Market Development***, according to indicators of:
    - number, distribution, and quality of service providers;
    - types and quality of instruments available in the market;
    - the structure and degree of competition in the market;
    - risks and transactions costs;
    - the price of services and subsidy incidence; and
    - awareness and willingness-to-pay for services on the part of SMEs.

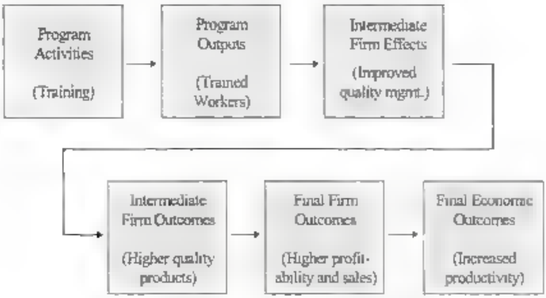
Measuring the effects of intervention on the development of markets for financial and non-financial services is a critical need of the new approach to SME intervention, but one for which indicators and methodologies are not well established.[24]

- ***Economic Impact***, according to indicators of:
    - the magnitude and durability of the effect of the service on SME performance (sales, exports, productivity, etc.); and
    - the developmental impact of the intervention at a sectoral or economy-wide level.

Evaluating the impact of interventions on SME performance can benefit from the use of a logical framework that clearly defines the program's objectives, and links activities and inputs to outcomes and impact. A logical framework for an SME assistance program is shown in Figure 3, using as an example a training program designed to help SMEs adopt and use quality management systems. The program's "output"—what are measured in most program evaluations—is simply the number of trained workers leaving the program. But the more important results to measure are the changes in enterprise behavior and processes that lead to improved product quality and subsequently to higher profitability and sales. Measuring the ultimate economic impact of the intervention requires going a step further, to the impact beyond the enterprise itself. For this, it is important to deal with issues of attribution (e.g., were increased sales due to the training, or to growth in aggregate demand?) and additionality (e.g., did the subsidy cause additional firms to train, or did it merely reduce the cost of training to firms that would have trained anyway?).

[24] The Committee of Donor Agencies for Small Enterprise Development is making progress in defining performance indicators for BDS programs and BDS market development. A preliminary Performance Measurement Framework will be tested in a set of BDS case studies to be presented at the Asia Regional BDS Conference in Hanoi, April 4-7, 2000.

**Figure 3: Logical Framework for Impact Evaluation**




Source: This framework was developed by Oldsman (1998) to evaluate BDS programs in Mexico.

In the field of microfinance, evaluation focuses on the measurement of institutional performance, with much less attention to measuring economic impact. This is based on the reasoning that the achievement of sustainability indicates that a service is demand-led, and when clients are willing to pay the full cost of services, sustainability is a proxy for impact. The same argument may be valid for other types of financially sustainable (non-subsidized) services. But for interventions that receive resources from the fiscal budget or external donors, the evaluation of economic impact is important—both to ensure accountability, and to justify the use of public resources for these programs against alternative uses.

## Conclusions

Many of the often-repeated justifications for scale-based enterprise promotion have little empirical support. But whether their actions are based on myth or reality, governments in both developing and industrialized countries do intervene to promote SMEs. Their SME assistance strategies often try to achieve a combination of equity objectives (alleviating poverty and addressing social, ethnic, and gender inequalities) and efficiency objectives (raising the productivity and profitability of firms). The confusion created by multiple objectives often leads governments to over-subsidize services that could be provided by the market. Direct provision of credit and non-financial assistance to SMEs tends to substitute for markets rather than dealing with the underlying causes of market underdevelopment.

In agreement with other recent studies[25], this report suggests that the overall business environment is the most important determinant of SME competitiveness and growth, as well as a necessary condition for the success of targeted assistance programs. Necessary reforms to improve the business environment go beyond macroeconomic and structural adjustment to the alleviation of microeconomic and institutional constraints that discriminate against small firms and reduce their growth and competitiveness.

Governments can accelerate the development of markets for financial and non-financial services suited to the special characteristics of small enterprises by promoting product innovation and building institutional capacity. In financial markets, improving SME access to credit requires an increase in the number of financial institutions that find lending to SMEs to be profitable, and therefore sustainable. This directs government intervention toward reducing the risks and transactions costs of lending to this segment of the market, strengthening the capacity of financial institutions to serve small-scale clients, and increasing competition in financial markets. The BDS market development approach follows similar principles: governments can facilitate greater demand and supply of non-financial services appropriate for SMEs by directing intervention toward market assessment, product development, building institutional capacity, and monitoring and evaluation of results. Efforts to develop private BDS markets should be complemented with a reduction and rationalization of traditional public sector involvement.

Interventions to develop markets for financial and non-financial services are only successful if their market-development effects outweigh their market-distortion effects. In turn, this depends upon whether the intervention resolves the underlying problems that constrain market development. This underscores the need to begin with a good understanding of the structure and performance of existing markets, and to build upon institutions and inter-firm networks that are already in place. It also draws attention to the importance of evaluating the impact of interventions—on institutional performance, market development, and ultimately SME competitiveness.

[25] See, e.g., Levy (1994).

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